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SUBJECT: MADAGASCAR: 2008 ECONOMIC OVERVIEW

¶1. (SBU) SUMMARY: In 2008, Madagascar recorded strong growth and improved macroeconomic performance despite external shocks. Real economic growth reached 7.2 percent. Fiscal policy improved tax revenue, while monetary and exchange rate policies contained inflation and prevented excessive volatility of the exchange rate. Public debt continued to decline. However, the current account deficit widened due to imports for two large mining projects and a surge in the international prices of food and oil. The budget deficit increased because of investment expenditures in infrastructure. The outlook for 2009 is grim, as the improved macroeconomic performance achieved in 2008 will likely be torpedoed by the current political crisis. END SUMMARY.

Construction and Telecommunications Drive Growth

¶2. (U) In 2008, the economy performed well compared to previous years. The GDP growth rate reached 7.2 percent (compared to 6.2 percent in 2007 and 5 percent in 2006). Nominal GDP peaked at USD 9.44 billion in 2008 compared to USD 8.05 billion in 2007. This performance resulted mainly from two large mining investments that were in the construction phase in 2008. Overall investment made up 37 percent of GDP, compared to 28.3 percent in 2007 and 25 percent in 2006.

¶3. (U) Growth rates in the secondary and tertiary sectors were respectively 8.8 percent and 8.9 percent, while the primary sector lagged behind with a growth rate of only 3.1 percent. Within this sector, agriculture grew at 4.6 percent due to the increase of commodity prices on the international market.
In the industrial sector, the construction materials industry was the most successful component with a growth rate of 20 percent. This performance resulted mainly from an increase in public infrastructure investment. Activities in the energy sector increased also by 12 percent due to the installation of new power generators and a growing demand for electricity. The beverage and iron industries also performed well with growth rates of 11 percent and 10 percent respectively. The Export Processing Zone grew only 8.6 percent in 2007, compared to 28.6 percent in 2007, in part because of the appreciation of the local currency (ariary). In the services sector, telecommunications and transportation led growth, with rates of 11 and 9 percent respectively.
¶4. (U) The services sector accounted for more than half of GDP (56.7 percent) and, despite the recent developments in mining, the secondary sector represented only 16 percent of GDP. The primary sector, which accounted for the vast majority of workers, accounted for only 27.3 percent of GDP.

Inflation Controlled Despite Global Price Spikes

¶5. (U) The objective of the central bank's monetary policy in 2008 was to keep inflation in the single digits by containing monetary growth to face rising food and oil prices. As a result of these rising basic commodity prices, inflation accelerated after April
¶2008. The GOM approved a temporary tax exemption on rice and lamp

oil starting from the second half of 2008 and froze electricity prices. Overall inflation in annual average terms was 9.2 per cent in 2008 compared to 10.4 per cent in 2007.

Government Deficit Creeps Up

¶6. (U) In 2008, the GOM modernized the tax code with a view to increasing tax revenue, while simplifying the tax system by reducing the number of taxes, particularly those that have low-yields and high administrative costs. Government revenue represented 12 percent of GDP in 2008. Administrative procedures were also reformed and employees received technical training.

¶7. (U) Despite these tax improvements, the budget deficit increased compared to 2007, reaching 4.7 percent of GDP or USD 427.6 million. This increase was driven by an increase in public expenditure (21.1 percent of GDP), mainly infrastructure investments, but also spending to combat the impact of the global food crisis. The supplemental budget law adopted in mid-2008 aimed at mitigating the impact of the rising food and fuel prices through social measures such as urban transportation subsidies, school nutrition programs, support for out-of-season rice production and labor intensive public works.

¶8. (U) Public debt continued to decline as it has since debt forgiveness occurred in 2005, and stood at 30 percent of GDP in 2008 (compared to 32.2 percent in 2007 and 39.1 percent in 2006). Foreign and domestic debt represented respectively 22.4 percent and 7.6 percent of GDP.

Improved Customs Services

¶9. (U) The customs code was amended in order to make customs clearance procedures more efficient and more secure. An electronic platform, tradenet, was installed to link all economic agents

involved in foreign trade, and the anti-fraud unit was strengthened.

Trade Deficit on the Rise

¶10. (U) Trade liberalization continued in 2008. Madagascar furthered its integration into SADC (Southern African Development Community) and continued reducing customs duties on products from the SADC countries. [Note: SADC suspended Madagascar's participation in March 2009 following the coup in Madagascar that month. The Malagasy transition government responded that it would pull out of SADC. End note.] The implementation of the interim Economic Partnership Agreement with the European Community took place during 2008.

¶11. (U) Exports increased from USD 1.209 billion 2007 to USD 1.428 billion in 2008. However in percentage of GDP, the ratio declined (15.7 percent in 2008 compared to 16.8 percent in 2007). Imports increased both in nominal terms (USD 3.268 billion compared to USD 2.191 billion in 2007) and as a percentage of GDP (41 percent in 2008 compared to 35.9 percent in 2007) due to the import demand of two large mining projects as well as high fuel and food prices during the first semester. As a result, the current account deficit reached 22.8 percent compared to 14.6 percent in 2007.

Mining Investments Cause Currency Appreciation

¶12. (U) Despite this deteriorating current account deficit, the balance of payments was in surplus in 2008 due mainly to large inflows of investment which represented 16.5 percent of GDP. The Ariary appreciated against major international currencies: the appreciation against the Euro and the Dollar was respectively 2.3 percent and 8.8 per cent in 2008. This balance of payments position allowed Madagascar to accumulate foreign exchange reserves estimated at USD 1.002 billion which represents 3.6 months of imports.

Threats to 2009 Economic Performance

¶13. (U) Political turmoil since January 2009 has already negatively impacted the economy in several ways:

- Hundreds of businesses closed because of widespread looting in late January. Thousands of workers were laid-off.
- The tourism sector was hit hard by the political crisis. Insecurity in the country caused cancellations of trips by foreign tourists, resulting in a slowdown in the transportation sector as well.

- Unemployment increased, thus reducing private consumption which represented more than 80 percent of total demand in 2008.
In addition to the political crisis, the economy is suffering from the impact of the global financial crisis on Malagasy exports. Thousands of workers in the export processing zone companies have been laid off since the end of 2008.

Comment: Trouble Ahead

¶14. (SBU) The entire economy is expected to slow down during 2009. The scope of the economic downturn is however difficult to estimate given the uncertainty regarding the end of the crisis. However, with some donors planning to cut foreign assistance, which accounted for around 23 percent of the government budget in 2008, the GOM may be heading for a fiscal train wreck. In order to return to its previous growth track, Madagascar must restore political and macroeconomic stability and investor confidence - unlikely events in the short term. End comment.

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